

## CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 362

July 3, 1973

### CANCELLATION OF INDEBTEDNESS INCOME

#### Syllabus:

A parent corporation loaned \$1,319,000 to its subsidiary with interest at 7 percent per year which was paid and deducted by the subsidiary. Subsequently the parent corporation forgave the debt, and it was credited to paid-in surplus.

The subsidiary corporation is solvent and is not thinly capitalized.

Taxpayer did not make an election under Section 24307 of the Bank and Corporation Tax Law and the related regulations (relating to adjustment of basis prescribed under Section 24918).

#### Question:

Does the cancellation of indebtedness by a parent corporation constitute taxable income to its subsidiaries?

#### Decision:

No.

Since the interest which was deducted here was paid, it should be noted that this decision has no application to cases involving the cancellation of non-principal debts from which the debtor corporation had previously derived tax benefits.

#### Discussion:

The California statutory definition of corporate gross income in Revenue and Taxation Code Section 24271 was adopted from Internal Revenue Code Section 61. Both the federal and the state definitions require the inclusion in income of "Income from discharge of indebtedness."

But a discharge of indebtedness does not always give rise to income under federal tax law. The gratuitous cancellation by a shareholder of a corporate indebtedness has long been regarded as a contribution to the capital of the corporation. Sec. 1.61-12(a), Income Tax Regs.; Autostrop Safety Razor Co., 28 B.T.A. 621 (1933), affirmed on this point 74 Fed.2d 226 (C.A. 2, 1934); Ligerwood Mfg. Co. v. Commissioner, 229 Fed.2d 241 (C.A. 2, 1956),

affirming 22 T.C. 1152 (1954), certiorari denied 351 U.S. 951 (1956); Carroll-McCreary Co. v. Commissioner, 124 Fed.2d 303 (C.A. 2, 1941); Bratton v. Commissioner, 217 Fed.2d 486 (C.A. 6, 1954). A contribution to capital is not includible in corporate income. See Internal Revenue Code Section 118.

This uniform and well established interpretation of the federal counterpart of the instant California statute would unquestionably be applicable here if it were not for the Legislature's repeal of Revenue and Taxation Code Section 24308. See Stats. 1965, c. 641, p. 1993, § 18. Former Section 24308 provided that:

If a stockholder or stockholders of a taxpayer cancels any indebtedness owing to the stockholder or stockholder by the taxpayer, such cancellation shall not constitute income to the taxpayer except to the extent that the taxpayer received a tax benefit, under this part, from such indebtedness.

Hence the repeal of Section 24308 raises the possibility that the Legislature intended to make all cancelled corporate indebtedness taxable.

Legislative history, however, clearly negatives the existence of any such intent to depart from settled Federal law on this point. Indeed, Section 24308 was expressly repealed as a federal conformity measure to eliminate a conflict with Section 24307 which is based upon Internal Revenue Code Section 108 (relating to reductions in basis). A federal conformity measure clearly provides no basis for finding a legislative intent to depart from federal law. The federal rule in question clearly applies here.

Express statutory authority, like that found in Internal Revenue Code Section 118, is not required to exclude a contribution to capital from corporate gross income. In enacting Section 118 in 1954, the Senate expressly noted that it "merely restates the existing law as developed through administration and court decisions." S. Rept. No. 1622, 83d Cong. 2d Sess. 190 (1954). Furthermore, the effect of Internal Revenue Code Section 118 may be reached by implication from Revenue and Taxation Code Section 24552. Section 24552 provides, with certain exceptions, that property acquired as paid-in surplus or as a contribution to capital has the same basis as it had in the hands of the transferor adjusted for any gain recognized to the transferor on such transfer.